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NASDAQ Proposes Listing Rules Relating to Compensation Committees

OCTOBER 12, 2012

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On September 25, 2012, the NASDAQ Stock Market (Nasdaq) proposed amendments to its corporate governance listing rules to implement the requirements of Rule 10C-1 under the Securities Exchange Act of 1934 relating to compensation committee member independence and compensation committee advisers. In addition, the amendments would require listed companies to have standing compensation committees with a written charter. The proposed amendments are subject to U.S. Securities and Exchange Commission (SEC) approval.

Effectiveness. The amendments relating to compensation committee advisers would be effective immediately upon SEC approval. Listed companies would not be required to implement the requirements relating to standing compensation committees and compensation committee member independence until the earlier of (i) their second annual meeting after SEC approval of the amendments or (ii) December 31, 2014. Accordingly, most companies would be required to fully implement the amendments by the time of their 2014 annual meeting. A company would have to certify to Nasdaq no later than 30 days after the applicable implementation deadline that it has complied with the amended listing rules.

Standing Compensation Committee. Nasdaq rules currently permit executive compensation to be determined either by a majority of a board's independent directors or a compensation committee comprised solely of independent directors. Nasdaq proposes to eliminate the first alternative and require all listed companies to have a standing compensation committee consisting of at least two independent directors.

Compensation Committee Member Independence. Nasdaq rules will continue to require that directors serving on a compensation committee be independent in accordance with current listing rules. Under the proposed amendments, compensation committee members will be required to meet an additional "bright line" independence test—similar to the first prong of the audit committee member independence test in Exchange Act Rule 10A-3—that would automatically disqualify a director from serving on the committee if the director accepts, directly or indirectly, any consulting, advisory or other compensatory fee from the company or a subsidiary. The prohibition on the receipt of compensatory fees applies only during the director's service on the compensation committee, without any look-back period. Compensatory fees would exclude:

- fees received for board and any board committee service; and
- fixed amounts of compensation under a retirement plan, including deferred compensation for prior service with the company, if such compensation is not contingent on continued service.

The board would also be required to consider whether affiliation with the company, a subsidiary or an affiliate of a subsidiary impairs the director's judgment as a member of the compensation committee. However, such affiliation would not automatically disqualify a director from serving on the compensation committee.

Nasdaq proposes to retain the current exception in its listing rules that permits a company to appoint to its compensation committee, for no longer than two years, a director who does not satisfy the independence requirements if:

- the compensation committee consists of at least three members;
- the director is not an executive officer or employee of the company or a family member of an executive officer; and
- the board determines that the director's membership on the committee is required by the best interests of the company and its shareholders.

The new rules provide for a cure period, allowing a director who ceases to be independent for reasons outside his reasonable control to remain on the compensation committee until the earlier of:

- the next annual shareholders' meeting, or at least 180 days if the meeting occurs earlier, and
- one year from the occurrence of the event that impaired the director's independence,

provided that the company gives notice to Nasdaq immediately upon learning of the noncompliance.

Compensation Committee Advisers. The proposed rule amendments would implement the requirements of Exchange Act Rule 10C-1(b) as to the authority of the compensation committee to obtain advice from compensation consultants and other advisers. Under the proposed amendments, the compensation committee must have:

- authority to retain compensation consultants, independent legal counsel and other advisers;
- authority to fund such advisers; and
- responsibility to consider certain independence factors before selecting such advisers, other than in-house legal counsel.

In assessing compensation committee advisers' independence, the compensation committee would have to consider the six factors identified in Rule 10C-1(b)(4). Nasdaq did not identify any additional factors to be considered, finding that the six factors will provide compensation committees with a "broad and sufficient range of facts and circumstances" to consider in making an independence determination.

Compensation Committee Charter. Current Nasdaq listing rules do not require a written charter for the compensation committee. Nasdaq proposes to require each company to certify that it has adopted a compensation committee charter and that the compensation committee will annually review and reassess the charter's adequacy. The compensation committee charter would be required to specify:

- the scope of the committee's responsibilities and how it carries out those responsibilities, including structure, processes and membership requirements;
- the committee's responsibility for determining, or recommending to the board for determination, the compensation of the chief executive officer and the company's other executive officers;
- that the chief executive officer may not be present during voting or deliberations on his or her compensation; and
- the specific responsibilities and authority with respect to compensation committee advisers.

Exemptions. Companies currently exempt from Nasdaq's corporate governance listing rules, such as controlled companies, limited partnerships and foreign private issuers that follow home country practices, would be exempt from the new compensation committee requirements. Foreign private issuers would be required to disclose in their annual reports filed with the SEC what requirements they do not follow and the home country practices they follow instead, as well as why they do not have an independent compensation committee.

In addition, smaller reporting companies—generally those with a public float of less than $75 million—would be exempt from the new compensation committee member independence requirements and the requirements relating to compensation committee advisers, including the adviser independence assessment. They would, however, be required to establish a compensation committee with at least two members who meet the current independence requirements and to adopt a formal written compensation committee charter or board resolution, which would not need to address the new compensation committee adviser requirements.

What Listed Companies Should Consider Doing Now. The proposed rules relating to compensation committee advisers will be effective immediately upon SEC approval of the proposed rules. Each Nasdaq-listed company may want to begin now to:

- review its compensation committee charter to determine how to reflect the committee's new responsibilities and authority with respect to compensation advisers;
- consider procedures to facilitate the compensation committee's independence assessment of current and prospective compensation consultants and other advisers, such as (i) the development of a compensation committee adviser independence questionnaire and (ii) revisions to its director and officer questionnaire to

solicit information about relationships between directors/executive officers and compensation committee advisers; and

- determine how to document the compensation committee's compliance with the compensation committee adviser independence assessment requirements.

As proposed, listed companies will not be required to comply with the new listing rules on standing compensation committees and compensation committee member independence until their 2014 annual meeting. Each Nasdaq-listed company may want to use this transition period to:

- form a compensation committee and adopt a charter, if it has not already done so;
- review its compensation committee charter, corporate governance guidelines and director and officer questionnaire to determine what revisions need to be made to these documents in light of the new compensation committee member independence requirements; and
- review the independence of those directors who are expected to be serving on the compensation committee in 2014 under the new "bright line" test and other independence standards.

Companies should also keep in mind that they will be required to disclose in their 2013 proxy statements any compensation consultant conflict of interest and how the conflict is being addressed, as a result of new Item 407(e)(iv) of Regulation S-K, adopted by the SEC this summer.

For Further Information

If you would like more information about the topics discussed in this *Alert*, please contact Elizabeth W. Powers, K. Oliver Rust, Richard A. Silfen, Darrick M. Mix, any of the members in our Capital Markets Group or the attorney in the firm with whom you are regularly in contact.